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STATE OF CONNECTICUT
INSURANCE AND REAL ESTATE COMMITTEE

SB 530, AN ACT ESTABLISHING A STATE NATURAL CATASTROPHE FUND

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Statement of the American Insurance Association

On behalf of its member companies that write more than 40 percent of Connecticut's homeowner's insurance market, and almost half of the state's property insurance market, the American Insurance Association (AIA) appreciates the opportunity to comment on Senate Bill 530, An Act Establishing a State Natural Catastrophe Fund.

Since Hurricane Katrina struck more than three years ago, there has been a vigorous national debate about the best way to manage and reduce natural catastrophe risk. Fortunately, the private property and casualty insurance industry is well-positioned financially and operationally to manage this risk, although federal and state reforms are needed to provide long-term stability to the existing private property-protection system. Nonetheless, some state public policymakers have proposed supplanting the role of the private insurance system through the creation of state Cat Funds and other government solutions that would undermine efforts to reduce risk and to encourage personal responsibility.

Cat Fund Overview

A Cat Fund is a state-run reinsurance facility intended to provide a government financial backstop to private insurers in the event of a hurricane or other major natural catastrophe. Advocates of this approach allege that Cat Funds are cheaper than private reinsurance because they remove the risk margin[1] that private insurers and

[1] The risk margin is the portion of the premium that provides for a return on the capital required to support the catastrophe exposure. Proponents of state Cat Funds assume that these governmental mechanisms

reinsurers must maintain. The reality, however, is that they merely redistribute, rather than reduce, costs.

Florida's Hurricane Catastrophe Fund was created in the immediate aftermath of Hurricane Andrew in 1992, when reinsurance availability in that state virtually dried up overnight. The legislature created the fund because primary insurers were faced with a stark choice – either continue to write homeowners insurance coverage with no reinsurance, or stop or severely cut back on writing that line of business altogether.

Thankfully, in the decade following Andrew, Florida hurricanes were infrequent. As a result, the Cat Fund's financial condition remained sound, and it built up substantial cash reserves. However, following the devastating hurricanes of 2004 and 2005, the Cat Fund ran out of money. The deficit is being paid off by a hurricane tax on most policyholders in the state, including many residents and businesses that are located in less risky areas (and may not even have been in the state when the hurricanes struck). In some hurricane scenarios, these assessments could last up to 30 years.

Today, 16 years after the Florida Hurricane Catastrophe Fund was created, Florida is still the only state with an active Cat Fund. Although such legislation has been considered in several Atlantic and Gulf Coast states, no other state has taken the gamble that a government-imposed mechanism can provide coverage more effectively than the private market.

Florida politicians recognize the state Cat Fund's precarious financial situation and are seeking help from Washington, in the form of a national Cat Fund that would buttress their state system when a major hurricane occurs. Legislation to create such a program was introduced in the 110th Congress, and one such bill passed the House last year. The result would be to export Florida's hurricane deficits to the rest of the country through taxpayer funding, as discussed below.

<u>Private sector capacity is adequate to spread and manage natural catastrophe risk</u>.

- Even with relatively calm years in 2006, 2007 and 2008, insured losses from natural disasters have increased over the past two decades; however, unlike terrorism, natural catastrophe remains a largely insurable risk for private insurers, provided they have the proper underwriting, rating, and risk mitigation tools.
- Following a tumultuous period immediately following the devastating 2005 hurricanes, the global catastrophe insurance markets have stabilized. According to the annual reinsurance market report at Guy Carpenter, "if the central theme of global insurance markets in 2006 was increased demand, then the theme of 2007 is increased supply."[2] And, although the reinsurance markets are expected to harden

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impose no charge for the risk they assume; however, this assumption ignores that government, like private investors, has multiple demands on its capital.

[2] Guy Carpenter, "The World Catastrophe Reinsurance Market" (2007), available at www.guycarp.com.

somewhat in 2009, private reinsurance is still very accessible.

- In addition to more than 15 new reinsurance companies that were created following Hurricane Katrina, the catastrophe bond market experienced record levels of issuance in both 2006 and 2007. Unlike government-created Cat Funds, where risk is concentrated according to the terms of the enabling legislation, the private market is truly global and allows risk to be spread without regard to state or national borders.

Cat Funds create hidden costs and unfair subsidies.

- While all states face some natural catastrophe risk, the type and magnitude of the risk varies greatly by state, by regions within a state, and by type of policyholder.
- With respect to the risk of hurricane, it is unfair to expect inland areas to subsidize coastal development and beachfront property, or small businesses to subsidize homeowners—yet such subsidies are integral to the design and financing of state Cat Funds.
- Any insurance system, whether private or governmental, faces a timing risk—that is, losses may occur early in the life of a program before there is sufficient offsetting revenue. Private insurers generally manage this risk through the purchase of reinsurance, while the only option for government may be deficit spending. Florida's Cat Fund anticipates the likelihood of deficit spending by requiring assessments against a broad range of policyholders for up to 30 years.

State Cat Funds do not reduce loss and may encourage unwise building and development.

- Cat Funds are designed to make insurance cheaper for policyholders who live in the riskiest areas.
- As such, they hide the true cost of risk in a way that may discourage people from living in safer areas or taking mitigation measures to reduce their vulnerability to catastrophes.
- Ultimately, this may result in overdevelopment in some of the most risk-prone and environmentally sensitive coastal areas—one reason why many environmental groups oppose the creation of new Cat Funds.

Conclusion

Creating a state Cat Fund in Connecticut may seem like an easy solution to the problem of "expensive" insurance. However, Cat Funds are inconsistent with the fundamental actuarial principle that higher risk should result in higher premiums. In doing so, they provide cheaper insurance for some policyholders only through unfair subsidies and deficit spending. Over the past three years, private insurance, reinsurance, and capital markets have demonstrated their resilience and their global risk-spreading capacity. Federal and state legislative solutions should build on this existing infrastructure and avoid creating new governmental mechanisms that may not withstand future hurricane winds. AIA urges the Committee to oppose Senate Bill 530.